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The recent reduction in the discount rate from 6.5% to 6%, the lowest rate since early 1978, is further confirmation of the hesitant performance of the economy so far this year. Nevertheless, the cumulative effects of declining interest rates, continued low oil prices, and substantial dollar depreciation will eventually lead to an acceleration in economic growth, although the process does appear to be protracted.

We are often asked: Does a reduction in interest rates really matter? Can any response be detected? To assess the importance of the declines in interest rates, bear in mind that the current lackluster performance of the economy is no indication that prior reductions in rates had no effect. To provide a precise answer, we would have to know the condition of the economy in the absence of these rate cuts. Presumably, it would be considerably weaker than its current state. Although some sectors of the economy seem little affected by the declines in rates, the auto and housing industries have been definite beneficiaries.

Auto sales totaled 11.2 million units at an annual rate in the second quarter, slightly above last year's level. The declines in interest rates have enabled the auto manufacturers to use incentive financing programs (or rebates in some cases) to promote sales. Although the programs have been costly for the auto manufacturers, sales have remained strong. Excluding last year, the second quarter's sales were the highest for any quarter since early 1979. As a hypothetical case, if the Federal funds rate were still at the recent peak of 11.4% (registered in the third quarter of 1984), it would be difficult to envision sales at the current level. Auto sales are expected to total 10.9 million units this year and 10.3 million units in 1987.

The housing industry has certainly been helped by the declines in interest rates. In 1984, a rise in mortgage rates from 11.55% (the average for a fixed-rate mortgage) in the spring to 12.25% in the fall contributed to a drop in housing starts, from 1.9 million units at an annual rate in the first half of the year to 1.6 million units in the fourth quarter. The general downward trend in mortgage rates since then led to a surge in housing starts, which averaged 2 million units during the first four months of 1986. Mortgage rates rose this year from about 10% in early spring to 10.7% in June, but are edging downward once again. Declines in mortgage rates from current levels will tend to support housing, but concerns about tax reform are already depressing multi-family starts. Under the House and Senate proposals, beginning next year investment in apartment buildings and other types of structures would be written off over a much longer period than under current law, without the benefit of accelerated depreciation. Housing starts are expected to total 1.89 million units this year and 1.70 million units in 1987, compared to 1.74 million units in 1985.

In sum, the declines in interest rates have been helpful in supporting the business expansion, but the effects have been uneven. Although real interest rates are still higher than at many times in the past, lower rates will not solve the fundamental problems for some industries, such as the oil industry. In addition, despite the sense that overall economic performance is below par, some sectors, such as consumer spending, are actually generating stronger growth than is generally perceived.

Bernard Schoenfeld



Economic Forecast

Percent Changes at Annual Rates

	Actual				Forecast				Actual		
	I	II	III	IV	I	II	III	IV	1984-1985	1985-1986	1986-1987
Gross National Product	5.7	3.7	7.5	8.2	8.1	8.5	7.8	7.3	5.7	5.4	7.7
Real GNP	2.9	2.2	4.0	4.1	3.9	4.0	3.7	2.7	2.2	2.5	3.8
GNP Price Deflator	2.9	1.4	3.3	4.0	4.1	4.3	4.0	4.5	3.3	2.8	3.9

	Actual		Forecast		Actual		Forecast	
	1986: I		1986:II		1984-1985		1985-1986	1986-1987
Consumer Spending	5.2%		5.9%		6.6%		5.8%	7.4%
Durable Goods	1.2		18.6		9.2		5.2	7.7
Nondurable Goods	-1.8		-0.9		4.6		3.6	7.2
Services	7.6		7.4		7.3		7.4	7.4
Business Capital Spending	-10.4		-0.2		11.3		0.9	1.4
Structures	-11.8		0.2		15.3		-0.6	0.5
Equipment	-9.8		-0.3		9.2		1.7	1.9
Residential Investment	12.4		18.7		3.6		13.1	7.0

	1985	1986	1987
Change in Inventories	\$39.9b.	\$11.7b.	\$7.5b.
Net Exports of Goods and Services	\$-105.8b.	\$-100.9b.	\$-78.5b.

	Actual		Forecast	
	1984-1985		1985-1986	1986-1987
Government Purchases	-9.4	7.0	10.7%	5.1%
Federal	-25.8	8.0	13.6	3.2
Defense	-5.9	6.7	10.5	4.8
Other	-60.8	11.7	23.2	-1.4
State & Local	5.6	6.3	8.5	6.5
Corporate Profits Before Tax	-1.5*	1.4*	-5.2	0.4
Corporate Profits After Tax	0.3*	0.8*	-2.6	0.3
Plant and Equipment Expenditures	-20.1	4.0	9.0	-1.4
Real Final Sales*	-1.7	5.2	3.9	2.1
Real Disposable Personal Income	5.5	7.9	1.6	3.7

Economic Indicators	Recent Data			Forecast		
	Apr.	May	June	1984-1985	1985-1986	1986-1987
Consumer Price Index**	-3.6%	-2.4%	n.a.	3.8%	2.5%	4.4%
Producer Price Index for Finished Goods**	-7.2	7.2	0.0%	1.8	-0.3	3.9
Industrial Production	0.6	-0.4	-0.5	2.2	0.5	2.2
Retail Sales**	0.9	0.7	0.2	6.4	4.5	7.3
Auto Sales (millions of units, a.r.)	11.1	11.3	11.0	11.1	10.9	10.3
Housing Starts (millions of units, a.r.)	2.04	1.86	1.85	1.74	1.89	1.70
Unemployment Rate	7.1%	7.3%	7.1%	7.2%	7.0%	6.5%
Merchandise Trade Deficit (a.r.)	\$144.9b.	\$170.5b.	n.a.	\$148.5b.	\$155.0b.	\$130.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

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*GNP less change in inventories, both in real terms.

*Year-over-year percent changes.

**Monthly percent changes are not annualized.

**Annual percent changes are December to December (not seasonally adjusted).

\$b. = billions a.r. = annual rate F = Forecast